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Fed-Up State Commissioners Urge More Flexibility and Judgment

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By Barbara A. Rehm

Community bankers who argue federal regulators are being too tough on them have a surprisingly vocal ally: state commissioners. Like their federal counterparts, the state commissioners are committed to ensuring banks operate prudently and customers are protected from abuses. Many just think the job could be done more reasonably.

"I don't necessarily disagree with some of the things [federal regulators] are saying, but they are using a sledgehammer to kill a gnat," said Mississippi Banking Commissioner John Allison.

State regulators share oversight of state banks with either the Federal Reserve Board or the Federal Deposit Insurance Corp. In most states they take turns in the lead; the state heads one exam, the feds the next.

But as a bank's condition deteriorates, federal regulators take a more controlling role in its supervision. That means the recent recession has concentrated more power in the hands of the federal regulators, which in turn has frustrated some state regulators.

The questions this raises for policymakers include: Is the dual banking system being weakened? Are talented bankers being prevented from managing their way out of a mess? Will that further concentrate the banking business? Will it thwart economic recovery?

The vast majority of banks in this country hold a state charter — 5,605 of the roughly 7,000 banks overseen by the Fed, FDIC or Office of the Comptroller of the Currency. So it may seem silly to ask if our system of offering state and federal charters is in jeopardy.

But the state banks' share of industry assets has been dwindling for decades and is now only a third of the $12.5 trillion total. What's more, it is the federal regulators — not the state — that have more clout when disagreement arises over a state bank's performance.

Jeff Vogel, a veteran examiner who became Wyoming's banking commissioner in 2002, said a recent exam, which his examiners led, resulted in separate ratings for the bank. The Fed's examiners viewed the state's rating as too generous and issued their own, lower rating. The FDIC used the Fed's rating to set the bank's deposit insurance premium.

"The bank gets a mixed signal, and the federal agency pretty much trumps our assessment of the bank," Vogel said.

Some state commissioners are refusing to sign enforcement actions initiated by the Fed or FDIC, saying they are simply too severe. This is not a frequent occurrence, but it is happening.

"Whatever you have to say as a state regulator really doesn't matter," said Tom Gronstal, who just completed nine years as Iowa's banking commissioner.

Gronstal said he has complained about it to federal regulators. "They were polite the first few times I said anything. They didn't really believe me. After that they just didn't want to hear it. They have their system and they are going to run with it."

It is rare for professional regulators to talk so bluntly about each other, but it is clear some state officials think the problem is bad enough that they need to speak up. Most of them acknowledged making some boneheaded calls themselves, and

nt of saying that he respects the federal officials they work with in the field.
ashington where the Fed and the FDIC are headquartered.

"Field examiners feel threatened. They feel like their jobs are in jeopardy if they vary from anything that Washington says to do," said Allison, who has worked at the Mississippi department since 1972 and been its commissioner since 2000. "No matter how great Atlanta is, Washington is going to have the final say-so."

Topping the list of complaints is that Washington is preventing field examiners from exercising judgment, or as one state commissioner put it "using any common sense."

"The federal regulators paint banks with a broad brush and the state regulators look at them individually," said Mick Thompson, who has led the Oklahoma banking department since 1992.

Thompson said, and other commissioners agreed, that an assessment of management talent is key to determining how much rope to give a bank. "It all goes back to management," he said. "If we have confidence in management, we are going to work with them a little bit more."

Chris Spoth, senior deputy director in the FDIC's division of supervision and consumer protection, said he is unsure why state commissioners view federal regulators this way.

"The FDIC has shared exam responsibilities with the states based on the same examination program and approach," Spoth said in an interview Tuesday. "Examinations are conducted and exam ratings are assigned locally. Examiner judgment is absolutely the key to a well-functioning exam program, and the last thing our staff in Washington would want to do is try to take it away."

Asked for its input, the Fed issued a statement saying it "values its close and constructive working relationship with the states and, of course, takes any concerns expressed by the state banking commissioners very seriously."

Fed spokeswomen Barbara Hagenbaugh added that the central bank's community and regional banks subcommittee "is working to address any issues related to the Federal Reserve's working relationship with the states."

Conflict between state and the federal regulators may stem from nothing more sinister than a difference in perspective: local versus national.

"They are trying to nationalize the application of their standards," said Tom Cardwell, who runs Florida's Office of Financial Regulation. "We say here in Florida we need to regulate to what is going on in Florida. I think that is the cause of some of the tension we are seeing."

Indeed, state regulators prefer a customized approach and claim they can pull this off because they know local bankers better than their federal counterparts.

Ray Grace, the chief deputy commissioner of banks in North Carolina, said the one-size-fits-all approach can exacerbate a bank's problems. For instance, banks rated 4 after an exam are typically hit with a formal enforcement action, which makes it tough to raise capital and can start a downward cycle that leads the bank to fail or sell at a big discount.

These orders can be counterproductive if the bank's management agrees to fix the problems identified, he said.

"You have to consider what do we lose versus what do we gain," Grace said. "If you are already getting the behaviors [called for in the order], then your gains are pretty minimal. If, on the other hand, public disclosure makes it impossible for the bank to raise capital, then you are using medicine that kills the patient."

Joe Face, who has worked at Virginia's Bureau of Financial Institutions since 1979 and been the commissioner since 1997, said this approach is hamstringing talented bankers.

"Good bankers can usually work their way out of problems, but they are not able to do so in many cases because the regulatory approach is impeding their abilities, particularly when it comes to the lending function, which is slowing economic recovery," Face said. "Many community bankers perceive elements of unfairness, secrecy, prejudgment and unwarranted criticism in remarks and actions by regulators."

Face is among the commissioners who said they have refused to sign some enforcement orders. "When they are just flat-

ators seem blind to the light emerging from the economic tunnel.

"This is just a horrible, grinding recession," said Grace of North Carolina. "But even saying that, I can't hold a candle to my federal counterparts when it comes to pessimism. They just don't see anything positive."

John Harrison, Alabama's superintendent of banks since 2005 and before that a banker in the state for 20 years, agreed.

"We are not going to be in this recession the rest of our lives ... and I think we have to be able to work with our banks and our bankers, especially those who have historically been very receptive to our recommendations," he said.

Until Washington realizes regulation is strangling the community banking business, Howard F. Pitkin, the commissioner in Connecticut, predicted the industry will become ever more concentrated.

"If the federal government doesn't recognize that they have regulation run riot, the whole thing is going to go away and we are going to have large banks, which will not serve anybody's interest except for the very largest businesses," said Pitkin, who has worked at Connecticut's banking department for 30 years and been its leader since 2006.

So, where do we go from here?

A number of state commissioners suggested shifting away from formal enforcement actions; using informal actions can give bankers more room to fix their problems rather than drive them over the edge.

And several recommended stripping enforcement orders to their essence — remove extraneous requests and repetitive reporting requirements. "A lot of the stuff that is required in these actions is superfluous," Gronstal of Iowa said. "It generates a lot of paper that someone has to review, but it isn't actually about collecting loans and liquidating real estate and other things necessary to turn the bank around."

Compromising with state regulators would be another welcome step. If the state examiner thinks a bank should raise its loan-loss reserve by $500,000 and the federal examiner thinks the figure should be $2 million, finding a number in the middle would go a long way to restoring a cooperative relationship, state regulators said.

Vogel also suggested rewarding state banks that are making progress. While federal regulators downgrade the ratings of state banks as they deteriorate between exams, they rarely upgrade banks that show improvement. "It can't always go one way," Vogel said.

Pitkin is thinking even more broadly, recommending a separate, simpler regulatory process for the smaller banks.

"There has to be some bifurcation of the system," he said. "The feds need to collaborate with the states and design a system that works, but it has to be done quickly."

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